ALLEN & OVERY

Brexit Law – your business, the EU and the way ahead

Financial services regulation – what impact will Brexit have on regulated firms established in the UK, Europe & third country jurisdictions?

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Overview

The UK contains the largest financial centre in the EU. The international financial market centred on the City of London is unique within the EU, attracting a wide range of global banks and other financial services providers. Whilst many foreign institutions have UK presences to participate in the UK financial market, a large number of non-EU financial institutions also use the UK as a hub to access clients and markets across the EU. Many EU firms also maintain branch presences in London. Brexit, in whatever form, will impact the financial services industry: the extent of that impact will depend on the negotiations that take place once the UK Government serve the formal notice to withdraw from the EU, and how far those negotiations preserve access for UK firms to EU clients. Since 1999, the EU has successively launched a number of regulatory initiatives aimed at ensuring an integration of EU financial markets and the removal of legal barriers which hindered the provision of cross-border financial services activity across Europe. These initiatives have led, for example, to the development of a 'single rulebook' (made up of a lengthy and complex body of primary laws (predominantly directives), delegated laws (including regulations and technical standards) and guidance) of common rules for the EU banking, investments and insurance sectors.

The directives that have been put in place since 1999 create a single market by enabling financial services firms authorised in one Member State (their home state) to carry on business in any other Member State (a host state) without the need for a separate host state authorisation either by establishing a local branch or on a cross-border basis – this is referred to as the "passport". The directives also establish the respective responsibilities of home and host state regulators for business with a cross-border element and provide a framework for regulators to cooperate with each other, both in relation to routine supervisory activities and in special cases such as changes of control, recovery and resolution planning and investigations.

In some areas, EU legislation also provides a framework within which non-EU firms may access the EU single market. This is generally restricted to wholesale business and depends on the non-EU regulatory regime being assessed as equivalent to the EU regime. In addition, there usually has to be some form of co-operation agreement in place between the relevant authorities in the non-EU country and the EU.

Since the financial crisis, there has been a marked increase in the desire to coordinate financial services regulation at a global level which has been driven, in part, by the G20 nations. As a result, in addition to developing the passport system, recent EU initiatives have focused on implementing the work of organisations such as the Financial Stability Board (**FSB**) or the Basel Committee on Banking Supervision (**BCBS**) in key areas such as resolution, prudential requirements and centralised clearing in the derivatives world. Any analysis of what impact Brexit will have has to consider the ramifications for global initiatives as well as the future interactions and arrangements between the UK and the EU.

This article is one of a series of specialist Allen & Overy papers on Brexit. To read these papers as they become available, please visit: www.allenovery.com/brexit.

Analysis

Will current legislation and regulation need to be amended?

Now that the UK has voted to leave the EU, it is highly likely that the law establishing the regulatory framework in the UK will need to change. Some of the key considerations are flagged below. What should be borne in mind is that regardless of the scale of the legal change required, it pales into insignificance when compared with the substantial impact that leaving the EU will have on the UK in numerous areas.

- Post-Brexit model – The adopted model will determine the legal changes needed. For example, if the UK were to seek to join the EEA (plus EFTA membership), adopting a model like Norway, the UK could continue to take advantage of the passport system and would be required to maintain existing regulatory frameworks. Whereas under a customs union or UK-EU free trade agreements models, the UK would have freedom to regulate its own financial services sector.
- European Communities Act 1972 (the **ECA**) – This act provides for the adoption of EU law into domestic law. If this is repealed, EU law implemented via primary legislation will be unaffected whereas secondary legislation made under the ECA will fall away. The extent of the UK's freedom to carve its own regime will depend upon the approach adopted as regards the ECA. During the negotiation period, the UK Government will need to consider which EU measures it would like to retain and address any gaps accordingly. This is likely to be a time consuming process which is compounded by the fact that much of recent EU financial services law has been made by way of regulation which has not required implementing measures in order to be effective. It will therefore be necessary to consider what new laws the UK may need. During the negotiation period (which may be for a period of two years or more) the UK will remain a Member State, and will continue to be subject to EU law, including new EU laws.

What are the likely implications for cross border activity?

In our view, there are four key aspects that should be considered in the context of cross border activity:

– Wholesale markets – The City of London is the pre-eminent location for trading in the foreign exchange markets and a significant centre for other wholesale markets. During the negotiation period, a key area of focus for the UK Government is likely to be establishing a (possibly new) framework that ensures that EEA firms which currently conduct business here under the passport system can continue to access the UK market.

– Continuing access to EU markets – The question of whether firms will continue to see London as the location for their EU headquarters will largely depend on the post-Brexit model. If this model results in the loss of the passport system, it would likely trigger some migration of global firms' EU headquarters away from the UK. One likely factor influencing the scale and speed of migration will be incoming EU rules permitting third (i.e. non-EU) country access. The key issue here, however, is that whilst the recast Markets in Financial Instruments Directive (**MiFID**) Directive and Regulation seek to provide third country access for wholesale business, the current iteration of the EU bank regulatory framework (**CRD IV**) does not.

– Market infrastructure – The regulatory structure arising under the MiFID enables cross-border access to exchanges, clearing houses and depositaries. Member States are required to ensure that firms based in other states are permitted to access regulated markets, central counterparties and clearing and settlement systems established in their jurisdiction. It will be crucially important for the UK Government to focus on arrangements that permit such access to continue in addition to ensuring that UK infrastructure providers are permitted to offer their services to EU institutions. Under the EU regulation on derivatives, central counterparties and trade repositories (**EMIR**), central counterparties authorised in any Member State are treated as authorised across the EU – if Brexit will result in EMIR no longer applying, the UK Government will need to consider whether it is possible to negotiate "grandfathering" provisions and/or seek "recognition" under EMIR. Clearly, the key unknown is the likely timing as regards such "recognition".

– 'The best of both worlds'? – Given the UK's historic role in formulating the EU's financial services laws, the regulatory framework is broadly similar to that of the UK. As a result, the broad structure of UK regulation will likely continue post-Brexit; however, leaving the EU may enable the UK authorities to 'switch off' provisions under different single market directives that have proved particularly burdensome and run counter to UK policy. Examples might include aspects of the Alternative Investment Funds Directive (**AIFMD**) and remuneration policy for banks. It is possible that post-Brexit, the UK authorities will seek to develop parallel EU and non-EU compliant frameworks to maximise the flexibility of the UK as a financial centre.

Will Brexit impact the UK's ability to influence financial services regulation?

Key aspects of EU financial services law are modelled on those of the UK, such as large parts of the EU market abuse regime and the framework arising from MiFID. As part of the EU, the UK has been able to use its expertise to influence the development of the EU financial services framework. To the extent the post-Brexit model that is adopted prevents the UK from being able to continue to exercise this influence on applicable new EU measures and initiatives to which its firms are subject when conducting business across the EU, this may have a detrimental impact on the UK's financial services industry to the extent UK firms were subject to those rules. This would be similar to the position that Norway, for example, currently faces.

In addition to the above, it is likely that Brexit will impact the UK's interaction with the European Court of Justice - it may be that the UK (or UK based clients) no longer have recourse to that institution (depending on the post Brexit model) and may be unable to rely formally on its judgments.

How will the impact of Brexit interact with global initiatives?

Much of recent EU financial services law is derived from fundamental principles that have been agreed at a global level. The work of the BCBS and FSB has shaped the direction of global thinking on prudential requirements and resolution regimes and such thinking has been encapsulated within EU directives and regulations. Given the UK's commitment to global reform in the financial services industry, it is difficult to see how the UK could substantially deviate from the initiatives that are already finalised or underway. Even if this is the case though, divergences in drafting, interpretation and application are likely to develop over time where the UK adopts national laws in order to meet international commitments rather than continuing to conform with the EU requirements. Such divergences would exacerbate the regulatory compliance burden facing financial services institutions and would likely be a key consideration for firms when deciding whether to conduct business here.

What does the UK's vote to leave the EU mean for you?

Whilst the full impact will only be known once the UK has negotiated the exit model, some of the key considerations for banks and other financial services providers are as follows:

Banking and investment services

For purely UK-focused firms – both UK entities and UK branches of foreign entities, we do not anticipate material impacts. For firms which use the passport, the key issue will be whether that system continues. It seems prudent to develop contingency plans based on a number of possible scenarios, including the position where the passporting regime is no longer available. In such circumstances, it will be necessary to consider how business models and group structures will need to change. This is of particular concern in the context of banking activities because CRDIV does not contemplate a framework for third country access. The need for an EU subsidiary that could provide banking services into the remainder of Europe under the passport system would become fundamentally important in this scenario. For EU firms that wish to provide banking services into the UK, it may be necessary to consider establishing a UK subsidiary.

Derivatives

In 2009, the G20 made a commitment to reform the derivatives markets globally. Given the UK's role in this commitment and the size of its derivatives market, the idea that the authorities will seek to deregulate that market is untenable. The global reforms that have taken place or are in the process of being finalised within key jurisdictions mean that the UK will continue to apply mandatory clearing, minimum margin requirements and reporting to a centralised trade repository. The primary open question is how the UK might seek to do that.

Funds

The impact of Brexit on fund managers will depend on the extent to which they are UK, EU or non-EU focused and the types of products they offer to investors. It is possible that firms will lose out on the marketing and management passport benefits that they currently benefit from. Under the UCITS regime, it is possible that Brexit will fundamentally impact UK domiciled UCITS as these will need to be EU domiciled and self-managed or managed by an EU management company. Under the AIFMD regime, the position is less clear and the timing and outcome of the exit negotiations will be key – for example, being classified a non-EU manager under the AIFMD, once those negotiations conclude, may not be so significant if the non-EU passport has been introduced.

Market infrastructure

If Brexit means that the benefits of MiFID and EMIR described above are no longer available, firms operating UK based trading venues or clearing or settlement systems will need to consider how they can continue to service EU-based firms or link up with EU-based market infrastructure. Given how fundamentally important the financial market infrastructure is to the operation of the UK capital markets, it is assumed that the UK Government will focus efforts on ensuring that EU firms can continue to be given access possibly through the adoption of grandfathering measures.

Insurance

Many of the issues explored above in relation to passporting apply equally to the insurance sector, and UK firms currently relying on the passporting regime may – if that system is not continued – will have to rely instead on authorisation as a third country branch under Solvency II. A key question for the insurance sector will be whether the UK is granted provisional or formal equivalence under Solvency II. If it is not (which does not seem likely), then UK-headquartered European-wide groups may be subject to group supervision both under the UK regime and under Solvency II. Similarly, European-based groups with UK subsidiaries and European entities which transact reinsurance business with UK-based firms will have to consider whether they will have to apply more onerous rules for capital purposes under Solvency II if the UK is not regarded as "equivalent". This will be less of a concern if the post-Brexit UK regime closely resembles Solvency II in its design.

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